DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

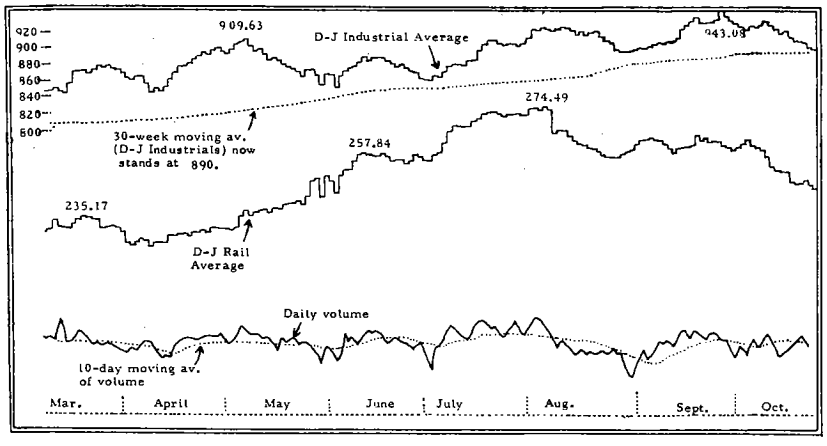
October 25, 1967 Letter 373

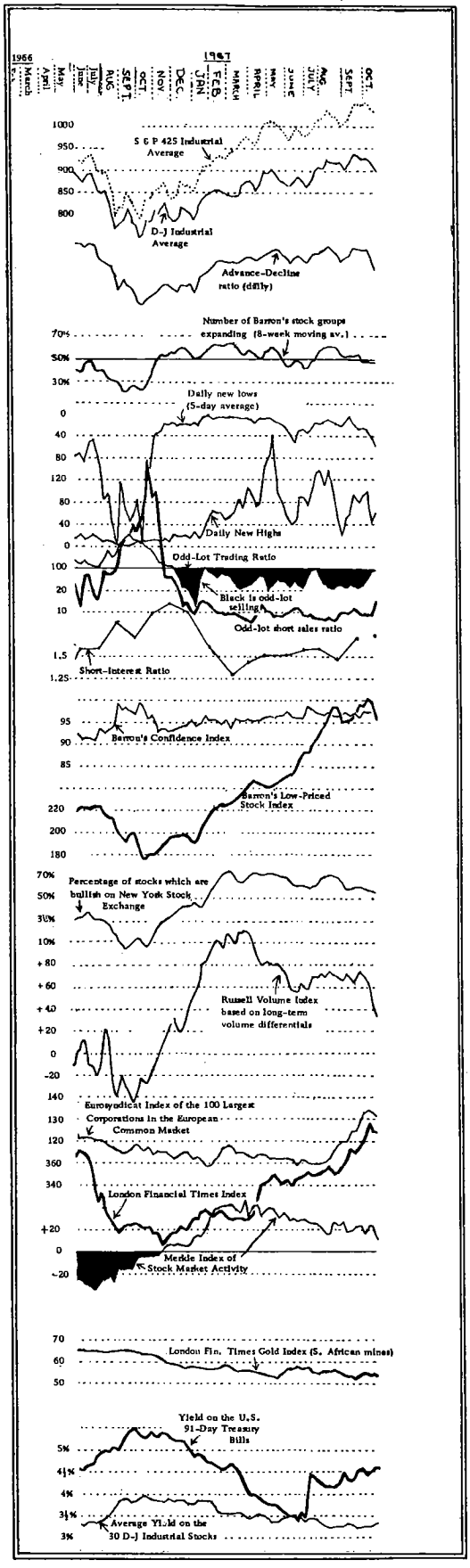
THE MARKET: October 4 was an historic day. On that day the yield on the S & P 425 Industrial Average sank to 2.88%. On the same day the yield on the S & P Aaa Bond Average rose to 5.76%. That means that the Aaa bond yields were exactly double that of the yield on the broad S & P 425 Average. In all history, this has never occurred before. To put it another way, the average dividend payout on the 425 Industrials would have to double in order to match the current yield on the highest-grade bonds. Nothing, but the expectation of perpetual rising profits and perpetual inflation could justify the present relationship between stock and bond yields.

In the face of this, it is doubtful whether corporate profits are going to rise substantially over the period ahead. Labor costs are rising, the nation's factories are running at only 83% of capacity, tight money is a fact of life, and strikes are cutting into profits. As for inflation, a number of factors are now militating against this "promise". First in importance is the collapsing bond market and the rise in interest rates. Although business can probably adjust to any given level of interest rates, it cannot adjust to a steadily rising rate of interest. Yet, this is what has been occurring in the money markets, and it has given financiers, mortgagemen and businessmen throughout the nation a case of the jitters.

The only reason the current nervousness has not turned to hysteria, in my opinion, is that people reason that "we came through the 1966 credit crush. The Fed bailed us out. Why can't we come through the present one in the same way?" But I have written before that tight money usually comes in two waves, with the second wave generally being the more severe. We are now in the midst of the second wave, and already it has taken interest rates far above the peaks of 1966 (which saw the first wave). I expect interest rates on Government bonds to go to 6% and above, interest rates on Aa bonds to climb above 7%, and bill rates to move above 6%. We should see the full brunt of the second credit crush upon us towards the end of 1967 or early 1968.

Turning to the stock market, the pattern of the Averages is now worth studying carefully. Following the August highs (see chart), the two Averages corrected with Rails breaking sharply. A subsequent rally during late-



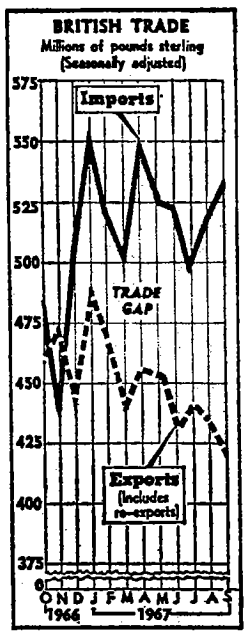

1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurovodicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

August and September took Industrials to a new 1967 recovery high of 943.08 (Sept. 25), but Rails failed by a wide margin to confirm.

A fresh break occurred characterized by further marked weakness in the Rails. During early October the carriers fell below their August bottom, thereby sinking to their lowest level since June. Industrials, however, did not confirm the Rail weakness, and they have since held stubbornly above their own August low of 893.72.

Thus, we now have the interesting picture of a non-confirmation by Rails on the downside. As far as Dow Theory is concerned, the two sets of points are now clear. It would require a complete reversal of Rail action and a hurdling by carriers of their August 4 high (274.49) to turn the secondary trend of the market bullish. Conversely, a further decline by Industrials below the August 30 low of 893.72 would confirm the Rail weakness and set the stage for a probable broad sell-off from here.

The Utility Average and the 40-Bond Average (see last Letter) continue to smash to new lows almost daily, and last week saw the broad 40-Bond Average fall below 78 for the first time since 1933. In all market history, a trend of Utilities and Bonds to new lows has proved adverse for the equity markets. My guess is that the current Utility-Bond action should again be accepted as a warning of trouble ahead.



MONEY: The world now views the U.S. as a sort of inflationary Frankenstein. Or, as last week's Bond Buyer (Oct. 9) put it, "For now, they (the Europeans) are scared stiff of inflation in the U.S. and, if possible, more scared of it in their own countries. In present lifetimes they have all been nearly burned alive by inflation, particularly France and Germany. Knowing most about that fire they dread it, and they are not about to let their children play with it."

At the Conference in Rio the "European Six" sought to put the brakes on U.S. inflation of the world money supply via "paper gold," and this included veto power by the Common Market plus a demand by France that no "Special Drawing Rights" be issued until the U.S. eliminates its budget deficit.

In Canada, where inflationary pressures have now driven government bonds above the 6% yield level and conventional mortgages above 9%, the Finance Minister stated, "I feel we must and will find some way to bring this inflationary movement under control, even, if necessary, by letting the economy develop a little more slack for a year or two while price and cost increases taper off."

In Britain the bank rate has just been boosted from 5½% to 6%. Two factors were responsible for this move. The first is the tightening U.S. interest rate structure, which threatens to siphon investment money out of Britain. The British bank rate was therefore raised as a protective device. The second factor is the horrendous British balance-of-payments picture (see chart). Late figures show British exports sliding again while imports rise. Thus, the September British BOP showed imports exceeding exports by $145 million, the worst showing in 15 months. In the face of this, the pound collapsed to new lows, and Bank of England support was needed to stave off an involuntary devaluation. How much longer the British can continue to support the pound is a matter of deep concern throughout the Free World. Devaluation of the pound would put immediate pressure on the dollar.

Meanwhile, the proposed U.S. surtax has been jettisoned, and all sectors of the U.S. bond market have sagged miserably, while new issues bearing the highest coupons since the 1930's are left 1/3 to 2/3 unsold after issuance. With Aa rated bonds now above 6% yields in many cases, the lower grade issues continue to sink, and this

THE MARKETS—MUNICIPAL BONDS

Yields Are Through '67 Roof to 33-Year High

Yields rise on new bond issues, but investors hesitate to buy

Business roundup

New York

Bond yields continued to swell and prices sagged while investors retained their lack of

Elizabeth, N.J., refused to sell bond i because interest rates crept above the l the communities had imposed on the

Stock-market comment

Bache & Co.: "If miscalculation

U.S. debt soars

By the Associated Press

Washington

The federal debt soared above $340 billion this week for the first time in history, the Treasury Department reported.

Total debt subject to the $358 billion ceiling fixed by Congress earlier this year rose to $340.3 billion last Monday, the department said.

At that time the $4.5 billion in new cash borrowed last week went on the books.

Inflationary pressures mount in Canada

By Roland Anderson
Special to The Christian Science Monitor

BUYER

Intelligence: For some time, European bankers on Wall Street have been talking about the probability of "double figure yields" on American debt issues. The harbinger may be here in the recently-issued Leasco Data Processing Equipment Corp. 20-year 5¾s which without warrants, are trading at 65 That puts the yield somewhere aroun 11 per cent or 12 per cent (most basi books don't go down as far as 65 It's a "B" rating by Standard & Poor's.

Buyers and sellers of bonds hold back as yields hit new unexpected highs

When bond yields started retreating from their 40-year highs last fall, there was a feeling on Wall Street that it would be decades before rates would get that high again. Now, less than a year later, rates are back up to astronomical levels.

Example: Philadelphia Electric Co.'s $75-million bond issue, marketed this week, carried a 6.10% yield— possibly the highest for a comparable issue since the Civil War. Even with that high a yield, retail demand was slow, indicating that buyers of corporate bonds want still higher rates.

At the same time, long-term U.S. government bonds

160 The Markets

Bank Rate Rise Foreseen In Britain

LONDON (AP) — The British bank rate, maintained at 5½ per cent since last May, appears likely to rise in response to upward pressures on world interest rates, especially in the United States, banking and financial experts forecast yesterday.

has led to the European rumor of a coming "double figure yield" (i.e., 10% or more) in the U.S. (see montage).

The "New Economists" in Washington are undoubtedly perplexed by their monetary Frankenstein. After all, they were just trying to give the American voters a perpetual boom, and what's wrong with that? Nothing, except that "perpetual booms" have always proved to be temporary, and their aftermath has always been collapse. The fact is that Wall Street is beginning to look aghast at Washington. It wonders what kind of a gathering mess is being generated. As one leading financial publication stated last week, "Washington should open a hot line to Wall Street. If one were in service, the White House and Capitol Hill, while they argue over tax increases and budget cuts, could hear of a worsening state of affairs in capital markets which could approach crisis proportions.

Perhaps the little montage which I constructed from a single day's headlines might serve to highlight the drama of today's monetary situation. To put it briefly, the U.S. has backed itself into an untenable corner even assuming a tax increase. Without the increase the situation is rapidly moving out of control.

NOTES & QUOTES: In a remarkable interview in Barron's (Oct. 16) Gilbert Haas opines that the great post-war boom has come to a close. Reason, the current low state of bank and corporate liquidity has run into an untenable demand for cash. Result: a coming monetary crisis with a nationwide scramble for liquidity. Haas believes that the post-war boom ended in the 4th quarter of 1966, and that since then the only thing accomplished by the Fed's flooding of the market with money has been to increase speculation in the stock markets to a fantastic degree. Thus, Haas sees nothing of substance under the frenzied run-up of speculative issues during 1967.

On October 18 the Wall Street Journal discussed the "Dash for Cash" in a front page article, and they documented the thesis that corporations are now frantically attempting to increase their liquidity. A statistical table shows corporate cash (quick assets) as a percentage of liabilities dropping from 38% in 1961 to 29% in 1965 to 24% today. Now the rush is on as corporations move into the crowded bond markets in an effort to raise cash. Many corporations are paying the highest interest rates in 100 years for new money; others are finding it necessary to offer inducements such as convertible features to their bonds.

Last week I turned back to Alfred Dana Noyes' description of the great Panic of 1907. There were many parallels between 1907 and today. Writes Noyes of 1907, "The rise on the Stock Exchange stopped abruptly; it now began to look as if the great speculators have gotten themselves into a trap. For exhaustion of credit resources now began to make itself felt in other quarters than the stock market.....The money-market crisis at the end of 1906 has brought the reckoning in other markets, and in 1907 their structure of inflated credit set the example of collapse....It had for many years been a cardinal doctrine, in American banking circles, that a panic like those of 1893 and 1873 would never again be witnessed in this country. The ground for this belief lay in the phenomenal increase of our economic strength."

* * * *

From the October 17 Janeway Letter: "We feel prompted to emphasize our conviction that the Administration has no plan for arresting, much less reversing, the upward spiral in long-term interest rates. Certainly it has developed no discussion whatever with any interested committees of Congress aimed at relieving or cushioning the pressure of its own demands on the long-term market—other than the obviously self-defeating expedient of directing Federal Agency borrowers to put lower-than-market coupons on new issues for public relations effect. We warn against the temptation to mistake public relations pricing by Washington of new issues for a plan to hold back or to reverse the new rate push."

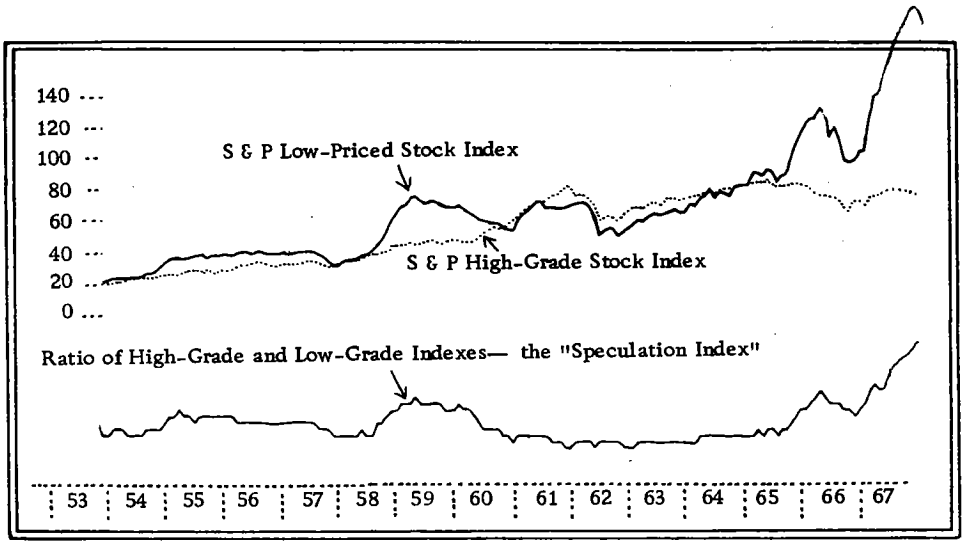
From the October 13 Money & Credit Reports by J. Irving Weiss, "President Johnson has evidently made an historic and momentous decision. He has turned his back on inflation and big budget deficits. At the same time, the key House Ways and Means Committee, which originates money bills, also has taken the same steps, but via a different route. Repercussions of these moves are still to come. The wildly speculative common stocks promise to be the first casualty."

From the October 16 International Harry Schultz Letter: "All significant economic news was negative in the past week. Worst of it all was the unbelievable announcement by McNamara that military construction awards were postponed 'because of the uncertain state of federal finances.' To paraphrase: the government had run out of money! We've known this figuratively for some time. Now it became literal. To let the outside world know that the once mighty US government had exhausted its purse was questionable tactics & will build no confidence, abroad or at home.... It was also revealed that government must borrow 17 billion in current year, of which 13 billion is underway & $4 billion remain. But with only 2.5 months left that's a lot of new pressure to put on the money market....You are witnessing the breakdown of a vast money machine, built over 22 years of warped-version Keynesism. The erosion was gradual at first but now the structure is busting up like a ship caught on a reef in a typhoon...."

RECORDS: I have mentioned on numerous occasions that "a bear market is out to break you." This is particularly true in the second psychological phase of a bear market. History shows, over and over again, that this is generally the most deceptive phase of a bear market. I consider that we are in the early part of the second phase of this bear market now.

The current early second phase has ushered in some of the most absurd ratios and statistics seen in generations. I have already discussed the current historic negative relationship between stock and bond yields. Another relationship worthy of mention at this time is the "speculation index," as I call it, or the ratio between the S & P Low-Priced Stock Index and the S & P High-Grade Stock Index. I have a record of this ratio going back to 1926. The speculation index recorded peaks in 1929, 1933, 1937 and 1945. On October 6, 1967, this index rose to 2.2, the highest level in a generation (see chart on page 4). Note that the High-Grades established successively lower peaks in 1965 and 1967. Against this poor action in the investment-grade issues, the Low-Grades have spiked up, roaring to an all-time high a few weeks ago. My interpretation of this action is that while quality stocks have been under distribution, the public and the speculators have run the "cats-and-dogs" through the roof, thus pushing the speculation index to a once-in-a-generation high.

In my opinion, this is a very dangerous state of affairs. All through the great bull market of 1949 to 1966, it was the blue-chip stocks which led the way. Again and again it was such issues as DuPont, General Motors, Union Carbide, and General Foods which pushed the market to new highs. But this situation changed radically after 1966. Over the past year,



all during the bear market rally since October, 1966, the glamor issues, the speculative issues and the low-priced issues have led the way. Many such issues have been pushed to ridiculous highs. The situation is one of frenzied speculation, poor market leadership and out-of-kilter ratios.

The aftermath of this speculative binge will be on the order of what occurred following previous speculative blow-offs. The market will smash the speculators and the water will ultimately be squeezed out of Wall Street. I believe we are approaching that time now. It is very close indeed.

LATER NOTES: As this is written the D-J Industrial has closed below its August low of 893.32, thereby confirming the prior penetration of the Rails below their own August low. Industrials have also confirmed the bearish indication of the advance-decline ratio which has already broken below its August low and now stands within a fractions distance of the June 5 low (at which time the Industrial Average was at 847.77). Should the June low on the A-D ratio be smashed , the next target for Industrials would be the 847.77 level.

Of interest also is the fact that our 5-day average of daily new lows has now climbed above the 5-day average of new highs for the first time since last January. This is just another indicator of mounting bearish pressure, and the new highs and lows tend to confirm the movements of the A-D ratio. Many analysts are attempting to explain the new lows away by saying that this indicator is now merely reflecting the weakness in Utility and preferred issues, a situation brought about by rising interest rates. I have never liked to explain away the new lows, however. The fact is that at 60, the 5-day average of new lows is at its highest level since October, 1966. Money pressure is fundamental, and the money stocks on the N.Y.S.E. are reflecting that fundamental force.

Note on the page 1 composite chart that the Russell Long-Term Volume Index has now dropped to 35, its lowest level since late-1966. In doing so, it has described a huge and bearish downward zig-zag. While such action on the part of the Russell Volume Index is no guarantee of collapse, the fact is that such patterns did precede the cave-ins of both 1962 and 1966. The action of the Russell Index now allows for collapse. I can describe the current formation in this Index as nothing else but ominous.

On the composite chart we also note that the number of Barron's stock groups in advancing trends (8-week moving average) is still at 48%, having held under the critical 50% level for the past three weeks. This indicates that market momentum has been ebbing, and that the action of the various stock groups has not been a sustaining force for the bulls for a period of almost a month.

Finally, it is of particular importance to see that the 30-week moving average of the D-J Industrials now stands at approximately 890. The Dow is now penetrating that important moving average. This means that for the first time since the great bear market rally began in October, 1966, informed investors have allowed the Dow to drop below its average price of the past 30-weeks. In other words, buyers of blue-chip stocks (as represented by buyers of the Dow type of issues) are now unwilling to pay their average price of the past 30-weeks. This is another bearish omen. During bear markets, it is normal for the Dow to remain under its 30-week moving average for long periods of time (or whenever the bear forces are exerting their primary pressure on the market).

OF INTEREST: Utilities have set something of a record. As of October 23, that Average had closed down on eighteen consecutive days. I have checked back a number of years and have not seen anything in the books to equal this string.